

## **MANAGING AND LIQUIDATING ASSETS ARE CHALLENGING TASKS**

Historically, FDIC/RTC have confronted massive challenges in the asset management and liquidation areas. From 1980 through 1996, the FDIC resolved 1,515 closed institutions with approximately \$243 billion in assets. From 1989 through 1995, the former RTC resolved 747 failed institutions with approximately \$403 billion in assets.

As of December 31, 1996, the FDIC managed approximately \$8.7 billion of assets in liquidation. The FDIC and RTC have disposed of nearly 99 percent of the \$646 billion in assets from financial institutions that have failed since 1980. Further, FDIC expects to reduce assets in liquidation by approximately 50 percent during 1997, to a level of about \$4 billion. It is expected that the vast majority of the remaining assets, which are the most difficult to sell, will be disposed of by 2000.

Despite the Corporation's success at liquidating assets from failed financial institutions, it will be some time before the activities of the FSLIC Resolution Fund can be terminated, and the cleanup of the S&L crisis completed. Asset claims administration, assistance agreement management and litigation, and FSLIC and RTC resolution and asset disposition activities will continue to require FDIC management into the next decade.

Although current and projected asset inventories are far below historic levels, many challenges remain to complete the job. The most difficult of these challenges continues to be the quick and efficient disposal of assets at the maximum price.

Assets have been disposed of through a variety of methods, including auctions, sealed bids, bulk sales, and negotiated sales, as well as ordinary collections. However, because many of the remaining assets are difficult to sell, FDIC needs to explore other innovative sales strategies and, in some cases, conduct legal reviews and analyses before liquidation can occur. Accordingly, to accomplish its goals in an effective and timely manner, FDIC must ensure that it provides extensive oversight for the operation and terminations of receiverships, the management of assets owned by receiverships, and the disposition of these assets. The Corporation's planned consolidation of Division of Resolutions and Receiverships (DRR) activities into the Dallas Office will present certain risks in this regard. The Corporation must ensure proper oversight and monitoring even though staff may not be in close geographical proximity to the assets themselves. Additionally, FDIC must be cognizant of, and ensure strict adherence to, a number of laws that affect the retained assets. The Corporation's efforts will reduce the cost to taxpayers for the thrift cleanup and help minimize deposit insurance premiums in the future.

### **ASSET MANAGEMENT REVIEWS QUESTION NEARLY \$1.7 MILLION**

During this reporting period, the OIG completed 7 audits that included two loan servicers, two asset management contractors, and three asset pool agreements resulting in the OIG questioning approximately \$1.7 million in fees and identifying \$11,000 in funds that could have been put to better use. One of those audits covered the performance of Texas Data

Control (TDC), Joint Venture, a loan servicer. The audit found that TDC (1) did not perform adequate loan servicing duties, (2) billed loan servicing fees on loans with little or no future economic benefit, (3) billed asset management and loan servicing fees on loans in bankruptcy that were not adequately monitored, and (5) billed expenses that were not authorized by the contract. As a result of these findings, the OIG questioned approximately \$1.3 million of TDC's fees. Management agreed to disallow the entire amount questioned.

The OIG also completed a performance audit of Greenthal/Harlan Realty Services Company (GHR), an asset management company RTC hired. The audit disclosed that GHR (1) did not reconcile cash balances, (2) overcharged management fees, (3) billed RTC for deficient and unnecessary services, (4) made unallowable and unsupported disbursements, (5) billed for unallowable subcontractor fees, (6) did not collect rental income, and (7) did not adequately inspect properties. As a result of these findings, the OIG questioned \$394,307 of GHR's billings.

In the course of resolving failed institutions, FDIC gains possession of subsidiaries that are unlike assets such as real estate or loans. Subsidiaries are distinct corporate entities and, in many cases, conduct their own business in areas such as loan servicing. These subsidiaries require additional legal procedures before their businesses are sold and the subsidiaries are dissolved. In its capacity as receiver of failed banks, designated FDIC officials become the sole shareholders or are appointed to the board of directors of the subsidiaries to develop plans to liquidate the assets and dissolve the subsidiaries.

During this reporting period, the OIG completed two audits covering eight subsidiaries. The OIG concluded that the subsidiary administration, accounting transactions, and internal controls over liquid assets were adequate. However, the OIG identified that the financial statements for each subsidiary did not present fairly, in conformity with the modified cash basis accounting, the financial position and the results of operations. Failure to fairly present the financial position may impact on determining the net worth of the subsidiaries during liquidation, and potentially reduce FDIC's recovery from their sales.

#### **LIQUIDATION REVIEWS LOOK AT "NEW" ASSETS**

Both FDIC and RTC developed several sales initiatives which will have a continuing impact on FDIC. These sales initiatives resulted in the creation of "new" assets in which FDIC now holds an interest and in partnerships with third parties. Examples include land funds and multiple investor funds. These limited partnerships were formed primarily to liquidate the assets. FDIC shares in the partnerships and cash-flow proceeds in accordance with the partnership agreement; cannot terminate the relationship other than by selling its own interest; does not have control over the management of the partnership or the assets; and if it chooses to sell, cannot necessarily expect a good price for its share in the partnerships due to its limited powers in the entities. Given these constraints, such arrangements warrant audit attention to ensure that the Corporation derives the full benefit of its relationship with these other parties.

During this semiannual reporting period, the OIG completed 10 audits of partnerships and questioned approximately \$250,000 of partnerships' income and expenses. Crosthwaite Associates, Limited Partnership, one of the partnerships audited, received \$190,274 in rent receipts and incurred \$211,387 in expenses. Of the \$211,387 in expenses reviewed, \$37,947 did not conform with the terms and conditions of the agreement or were not supported.

Further, Crosthwaite did not report \$9,883 of income; provide FDIC with \$11,986 contained in two bank accounts; or deliver all vouchers, invoices, other writings, and all books and records of Crosthwaite pertaining to the business and financial affairs of the mortgaged property. As a result of these findings, the OIG questioned \$59,816. Management agreed to disallow the entire amount questioned.

Another audit involved controls over securitized loans. One method that FDIC and RTC have used to liquidate loans is to sell loans in the form of mortgage-backed securities, commonly called securitized loans. A mortgage-backed security is a pool of mortgage loans used as collateral to back securities sold to investors in the secondary market. Simply stated, principal and interest received from the underlying mortgages is paid monthly to the investors holding certificates backed by the loans securitized. In this method of selling loans, FDIC and RTC set up two types of funds--the Credit Enhancement Reserve Fund and the Payment Retention Fund (PRF)--for each securitization transaction. Credit enhancement reserve funds are established to achieve the desired credit rating for the securities issued and to make up losses to investors resulting from defaults of securitized loans. Credit enhancement reserve funds are managed by trustees with the help of loan servicers. The purpose of the PRFs is to provide the master servicer with funds to make up for any shortfall in loans that are not transferred from the interim servicers. Any balance of PRFs, when all the loans are securitized, should be returned to FDIC.

During this reporting period, the OIG completed an audit that covered two securitization transactions involving two credit enhancement reserve funds. The OIG found that for both transactions, the servicer adequately managed loans and supported reserve fund loss calculations. However, in one transaction, the servicer overstated real estate losses, resulting in the trustee drawing an excess amount from the credit enhancement reserve fund. As a result of this finding, the OIG questioned \$170,178. The OIG also noted that the trustees for both transactions invested the reserve funds in permitted securities.

In the PRF audit, the OIG determined that RTC did not ensure that it received PRFs from master servicers accurately and timely. Specifically, as of February 21, 1996, master servicers had not returned approximately \$413 million of the funds' original balances. Also, master servicers returned funds from 52 to 1,259 days after the return dates designated in their servicing agreements. Further, RTC did not properly account for funds received during the interim servicing period. In addition, the master servicer selected for review did not provide documentation to support retention of \$3,556,926 and inappropriately reimbursed the PRF, resulting in the OIG questioning that amount. As a result of our audit, FDIC requested that master servicers return \$233 million of the \$413 million that had not been returned. As of February 28, 1997, only \$82.3 million was still outstanding. In addition, FDIC recovered \$3.6 million from the master loan servicer.

## **SUPERVISORY AND REGULATORY ACTIVITIES ARE KEY TO FDIC'S SUCCESS**

FDIC's supervisory and regulatory responsibility is designed to ensure the safety and soundness of federally insured depository institutions. FDIC is the primary federal regulator for over 6,300 state-chartered banks whose deposits are covered by FDIC insurance funds. The Corporation also has certain backup supervisory authority, for safety and soundness purposes, for state-chartered banks that are members of the Federal Reserve System, national banks, and savings institutions. With the increased financial strength of the banking industry, the number of failed banks has decreased considerably. During the calendar years 1995-1996, 12 banks failed compared to 54 banks that failed in the years 1993-1994. In this rather healthy environment, FDIC's focus is on identifying and addressing the potential risks to the banking industry and deposit insurance funds rather than on resolving failed institutions. FDIC's challenge continues to be to maintain the viability of the federal deposit insurance funds by identifying and taking action on any institution involved with activities that are unsafe, unsound, illegal, or improper before the activities can become a drain on the insurance funds.

The banking industry is a rapidly changing marketplace, with fewer yet larger and more complex institutions, which are moving into such new services as cyberbanking and smart cards. It is also an industry susceptible to regional and economic sector fluctuations in the economy. Further, there is continuing interest in legislative changes affecting the banking industry, such as merging bank and thrift charters. All these variables present challenges that the Congress and public look to FDIC to manage in a manner that ensures the safety and soundness of banking institutions and the insurance funds that back depositors.

### **OIG REVIEWS CAUSES OF BANK FAILURES**

The OIG can play a key role in assisting the Corporation in its efforts to identify the risks to the banking industry and bank insurance funds. During the reporting period, the OIG conducted two reviews that focused on the causes of bank failures. One such review was a material loss review of the failure of the Bank of Newport, Newport Beach, California. This review identified the causes for the failure of a specific bank, as required by section 38(k) of the Federal Deposit Insurance Act. In this review, the OIG determined that the Bank of Newport failed because of (1) fraudulent lease transactions, (2) weaknesses related to loan underwriting practices, (3) a concentration in construction and development loans, and other commercial real estate loans, (4) high overhead expenses, and (5) inadequate oversight by the bank's management.

The OIG also conducted another review and made a broader assessment of all bank failures over the course of a year, to complement the more detailed assessments of the causes for failure of the specific bank identified in the material loss review. The overall goal of this review was to identify the institutional practices which caused the 1995 failures and respective losses to the Bank Insurance Fund (BIF). The specific objectives were to identify the key problems of insured bank failures that occurred in 1995 and identify any trends or unique characteristics among the failed institutions.

During 1995, six banks insured by the BIF failed, with combined assets of \$867 million. Estimated losses to the BIF, at the time of failure, totaled more than \$77 million. The

principal conditions of failure that were common to most of the 1995 failed banks included (1) weak loan underwriting, (2) concentrations of credit, (3) high overhead expenses, (4) imprudent bank management, and (5) negative economic factors. Our report on the 1995 bank failures was informational and did not include recommendations. DOS management did, however, inform us of recent projects that emphasize changes in the examination process regarding our reported issues, including a more structured risk assessment approach in the safety and soundness examination program and a pilot program that allows users to generate market data for selected property types.

#### **CORPORATION IMPLEMENTS IMPORTANT CORRECTIVE ACTION**

In the area of resolution, FDIC took significant corrective action during this reporting period for a report the OIG issued in the previous semiannual reporting period. The OIG issued a follow-up audit report entitled *Cost Estimate Process for Bank Resolutions*. The objective of the audit was to ensure that the resolution cost estimate process properly captured all aspects of resolving and liquidating failed institutions. In this report, the OIG made seven recommendations to improve the reliability of resolution cost estimates. In response to our recommendations, DRR has initiated a Corporate Operating Plan Project entitled the Transaction Performance Measurement Project. This project substantially addresses all our recommendations related to establishment of an economic assumptions database, allocation of indirect expenses, and development of asset-level performance measures.